Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Klehs	Analyst:	Anne Mazur	Bill Number:	AB 1614
Related Bills:	See Legislative History	Telephone:	845-5404	Amended Date:	August 15, 2005
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT:	Amnesty Clean-Up

SUMMARY

This bill would provide relief to certain taxpayers with respect to the tax amnesty program administered by the department as follows:

1. Increase the interest rate paid on any resulting overpayments the same as the rate of interest paid on underpayments for corporations that made amnesty protective claim payments.
2. Require the department to return amnesty protective claim payments upon taxpayer's written request within 45 days of the request.
3. Provide an exception to the amnesty penalty for underpayments attributable to a post-amnesty change in regulation, legal ruling, or published court decision.
4. Provide an exception to the amnesty penalty for taxpayers that paid at least 90% of the total tax for a taxable year by the last day of amnesty, March 31, 2005.
5. Permit taxpayers to request relief from the amnesty penalty on a pre-payment basis from the Chief Counsel of FTB with post-payment appeal of that determination on an abuse of discretion standard.

Each of these provisions is discussed separately in this analysis. The bill also contains double jointing language to prevent chaptering issues with AB 911 (Chu), as amended June 20, 2005.

SUMMARY OF AMENDMENTS

The August 15, 2005, amendments deleted provision that would have changed the Revenue and Taxation Code relating to Sales and Use Tax Law and inserted clean-up provisions related to the recently concluded income and franchise tax amnesty program.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to prevent an unfair burden on taxpayers that may occur as a result of the tax amnesty program.

Board Position:			Department Director	Date
________ S	________ NA	________ NP	Will C. Bush	08/25/05
________ SA	________ O	________ NAR		
________ N	________ OUA	___X___ PENDING		

EFFECTIVE/OPERATIVE DATE

As an urgency statute, this provision would be effective and generally operative for penalties issued on or after the enactment date. According to the author, the intent was to make the provisions of this bill retroactive to the end of amnesty, March 31, 2005. The bill would need to be amended to achieve that result.

POSITION

Pending

SUMMARY OF ECONOMIC IMPACT

Estimated Revenue Impact of AB 1614 (in millions)				
	2004/2005	2005/2006	2006/2007	**Total**
Increase Corporation Overpayment Interest Rate	– $12	– $28	– $44	**– $84**
Return Of Protective Claim Payments Upon Request	none	none	none	**none**
Amnesty Penalty Exclusion For Post-Amnesty Law Changes Affecting Amnesty Years	none	none	none	**none**
90% Safe Harbor For Amnesty Penalty				
Reduction in penalties	– 19	– 7	– 4	**– 30**
Acceleration of protective claims	– 120	60	60	**0**
Chief Counsel Relief Of Amnesty Penalty	– 9	– 3	– 2	**– 14**

Note: Overlap between the 90% safe harbor and chief counsel relief provisions will result in a cumulative total for all proposals that is less than a revenue loss of $128 million.

This estimate does not consider the possible changes in employment, personal income, or gross state product that would result from this bill.

Individual revenue discussions are included separately below for each provision.

1. INCREASE CORPORATION OVERPAYMENT INTEREST RATE

EFFECTIVE/OPERATIVE DATE

If this proposal were enacted as an urgency statute, it would be effective upon enactment and apply to determine interest on overpayments attributable to protective claim payments made in lieu of participating in the amnesty program and that were made on or after January 1, 2005, and before April 1, 2005, as of the date the overpayment becomes effective.

ANALYSIS

CURRENT FEDERAL LAW

The interest rate the IRS pays to corporations on overpayments is the short-term federal rate plus two percentage points. The underpayment rate for corporations is the short-term federal rate plus three percentage points. For larger corporate overpayments, i.e., any portion that exceeds $10,000, the rate is reduced to the sum of the short-term federal rate plus one-half of one percentage point. These rates are adjusted quarterly, with each successive rate becoming effective two months after the date of each quarterly adjustment. As of April 1, 2005, the federal interest rate for corporate overpayments was 5% while the rate for underpayments was 6%.

CURRENT STATE LAW

Current state law provides that in the case of any corporation, the overpayment rate specified is to be the lesser of 5% or the bond equivalent rate of 13-week U.S. Treasury bills, beginning on or after July 1, 2002. California modifies federal law by requiring that the overpayment rate for individual taxpayers be the same as the underpayment rate. The adjusted annual rate of interest applies to both overpayments and underpayments. The rate of interest on overpayments and underpayments is determined semi-annually. For the period July 1, 2005, through December 31, 2005, the adjusted annual rate of interest is 5%, except the rate on overpayments of corporate franchise and income tax is 2%.

THIS PROVISION

This provision would increase the overpayment interest rate paid to corporations to 5%, which is equal to the underpayment interest rate, for corporate taxpayers that paid and filed protective claims during amnesty.

IMPLEMENTATION CONSIDERATIONS

The department's Business Entities Tax System (BETS) currently calculates the 2% interest rate on the total amount of an overpayment issued to a corporation. Since this automated system cannot accommodate the change made to the interest rate on an overpayment limited to amnesty protective claims, the interest rate adjustment would need to be done manually by staff.

LEGISLATIVE HISTORY

SB 1100 (Senate Budget Committee, Stats. 2004, Ch. 226), among other things, established a tax amnesty program.

AB 1768 (Oropeza, Stats. 2002, Ch. 1127), among other things, established a lower interest rate to apply to refunds and credits of corporation overpayments.

PROGRAM BACKGROUND

To encourage taxpayers to participate in the Amnesty Program, the amnesty legislation established an additional penalty on amounts owed or new amounts assessed for taxable year 2002 and prior taxable years that were not paid by March 31, 2005, the end of the amnesty period. The penalty is generally equal to 50% of the interest on the amount owed or to be owed.

Protective claims are payments taxpayers estimated might be owed in connection with ongoing or anticipated audits, protests, appeals, or settlements. A protective claim differs from the traditional claim for refund in that the taxpayer did not have to set forth the specific grounds on which the claim is based at the time the payment was made. As of July 31, 2005, 642 corporate taxpayers made payments and filed protective claims in the amount of approximately $3.5 billion.

FISCAL IMPACT

The department's costs to administer this proposal would require the interest rate adjustment to be done manually by staff as described under Implementation, which would be done at a minor cost to the department.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Based on data and assumptions discussed below, this provision would result in the following revenue losses annually beginning in 2005-06.

Estimated Impact of Adjusting the Interest Rate On Overpayments to that of Underpayments (in millions)		
2004-05	2005-06	2006-07
-$12	-$28	-$44

This estimate does not consider the possible changes in employment, personal income, or gross state product that would result from this bill.

<u>Revenue Discussion</u>

Prior to the close of the amnesty period, corporations made payments totaling $3.5 billion accompanied by protective claims for refunds. It is estimated that roughly 45% of these payments, or $1.58 billion, will be refunded. The estimate assumes that 1/3 of this amount, $525 million, will be refunded in each of the next three fiscal years. Since most of the overpayments were deposited in March 2005, refunds issued during fiscal year (FY) 2005/06 will, on average, earn interest for nine months. Refunds issued in FY 2006/07 will, on average, earn interest for 21 months, and refunds issued in 2007/08 will, on average, earn interest for 33 months. The current interest rate differential between overpayments and underpayments of 3% was applied, with compounding where appropriate, to the amounts anticipated to be refunded in each fiscal year (e.g., for refunds issued in 2005/06: $525 million x 3% x .75 years = $12 million in interest).

It should be noted that the assumption above that all issues will be resolved within three years may be too short in some cases. If cases are not all resolved within three years, the total revenue loss from this proposal would increase, but the revenue losses in the first year or two would decrease. Under the state's accruing methods, revenues from these refunds are recognized in the fiscal year prior to the year in which the refund is actually issued.

ARGUMENTS/POLICY CONCERNS

By adjusting the interest rate on overpayments for only the class of corporate taxpayers that paid and filed protective claims to avoid the amnesty penalty and not corporate taxpayers with overpayments outside of amnesty, this proposal could raise a constitutional challenge based on the argument that preferential treatment is given to an identified class of taxpayers.

2. RETURN OF PROTECTIVE CLAIM PAYMENTS UPON REQUEST

ANALYSIS

FEDERAL/STATE LAW

The federal American Jobs Creation Act of 2004 added IRC § 6603, which among other things streamlined and simplified the federal system of applying advance tax deposits to suspend the running of interest. Accordingly, the IRS recently issued procedures applicable to tax deposits made after 10/22/2004. These procedures include instructions for designating remittances as deposits, treatment of undesignated remittances, treatment of deposits made during an examination, treatment of deposits made after an examination, conversion of amounts previously deposited as cash bonds to tax deposits, requests for return of deposits and determination of underpayment interest where a tax deposit has been made.

These new procedures apply only to payments made for a tax year after a return is filed and before a final liability is assessed that are specifically designated as deposits. Payments made before a return is filed are estimated tax payments, on which the statute of limitations runs if no return is filed. Payments made after a final liability is determined are applied to the final liability according to normal payment allocation rules, normally to the year designated, then to the oldest year.

Under current California law—section 19041.5 and FTB Notice 99-9—unless the taxpayer specifically designates an advance payment as a cash bond, it will be treated as a prepayment of tax liability expected to be due for the year and stop the running of deficiency interest as well as earn interest if it is ultimately refunded. FTB will refund any deposit the taxpayer did not designate as a cash-bond on request where there is no final liability.

THIS PROVISION

This provision would require the department to return within 45 days of a written request any payment made by a taxpayer on or after January 1, 2005, and before April 1, 2005, that is not applied to satisfy a liability, including final deficiencies and self-assessed amounts. By its express terms, the provision would not prevent the imposition of the post-amnesty penalty.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department's programs or operations.

LEGISLATIVE HISTORY

AB 115 (Klehs, 2005/2006), as amended August 23, 2005, would amend section 19041.5 to repeal the cash bond provisions and incorporate the provisions of new IRC section 6603 by reference. These amendments would provide that payments made during protest or appeal would be treated as deposits until the protested or appealed deficiency became final.

FISCAL IMPACT

This provision would not significantly impact the department's costs. Current department procedures can accommodate this proposal and process refund requests within the required time

ECONOMIC IMPACT

This proposal does not impact income tax revenues.

POLICY CONCERNS

The department believes that this provision is declaratory of existing law and that procedures are currently in place to return such advance payments upon request by a taxpayer as contemplated by this provision. As such, the department already has the authority and procedures to accommodate quick returns of deposits as contemplated by this provision. Under current law, unless the taxpayer specifically designates an advance payment as a cash bond under section 19041.5, the payment will be treated as a prepayment of tax liability expected to be due for the year and stop the running of deficiency interest as well as earn interest if it is ultimately refunded. FTB will refund any deposit the taxpayer did not designate as a cash-bond on request where there is no final liability. AB 115 (Klehs), as amended June 20, 2005, would amend section 19041.5 to incorporate the provisions of the new IRC section 6603. As such, payments made during protest or appeal would be treated as deposits until the protested or appealed deficiency became final.

3. AMNESTY PENALTY EXCEPTION FOR POST-AMNESTY LAW CHANGES AFFECTING AMNESTY YEARS

ANALYSIS

STATE LAW

SB 1100 (Stats. 2004, Ch. 226) authorized FTB to administer a tax amnesty program for individual and business entity taxpayers with respect to tax liabilities for taxable years beginning before January 1, 2003. The amnesty program was conducted during the period beginning February 1, 2005, and ending March 31, 2005. Taxpayers participating in amnesty received a waiver of unpaid penalties and fees. Taxpayers that did not participate, but had an outstanding balance at the end of amnesty, would be subject to a penalty in an amount equal to 50% of the current interest owing on their account. In addition, taxpayers that have final amounts become due for amnesty-eligible years after the conclusion of amnesty, whether from additional assessments or self-assessed amounts, are also liable for the amnesty penalty.

THIS PROVISION

This provision would make an exception to the amnesty penalty for underpayments attributable to a regulation, legal ruling of counsel, or a published federal or California court decision that becomes final after the end of the tax amnesty program period (March 31, 2005).

IMPLEMENTATION CONSIDERATIONS

Implementing this proposal would not significantly impact the department's programs or operations.

This situation contemplated by this provision is common. Generally, any published court decision will impact a year that is open for assessment. This provision would be implemented manually, generally by audit staff in the course of completing an examination. In the case of automated assessments, taxpayers would have to inform the department that an applicable law change exists.

It is the intent of the author that this provision not apply with respect to a taxpayer that is the petitioner in a court case resulting in a published decision. The author may want to amend the provision to clarify this point.

OTHER STATES' INFORMATION

Eleven states[1] and New York City had an amnesty program during 2003. Research showed that of those states, *Illinois, New York*, and *Virginia* imposed strict penalties or interest rate increases and did not expressly provide any relief from those penalties or interest increases for existing assessments or for any future liabilities that occur after the amnesty period.

FISCAL IMPACT

This proposal would not significantly impact the department's costs.

ECONOMIC IMPACT

It cannot be predicted which, if any, laws or regulations will be altered in the future. Consequently, no revenue effect can be assigned to this proposal.

4. 90% SAFE HARBOR FOR AMNESTY PENALTY

ANALYSIS

THIS PROVISION

This provision would provide an exception to the post-amnesty penalty if a taxpayer paid at least 90% of the total tax for a taxable year before the end of the tax amnesty program period (March 31, 2005).

[1] Arizona, Colorado, Florida, Illinois, Kansas, Maine, Massachusetts, Missouri, New York, North Dakota, and Virginia.

IMPLEMENTATION CONSIDERATIONS

The department's taxpayer accounting systems would be reprogrammed to determine whether a taxpayer meets the 90% threshold. These program changes would not significantly impact existing programs and would not require any additional resources. To the extent that this provision has retroactive affect, penalties imposed prior to the effective date of this bill would be manually reviewed and processed.

Department staff assumes that the 90% threshold would be redetermined with each post-amnesty final deficiency or self-assessed amount. A taxpayer that is within the safe harbor with respect to a post-amnesty assessment may no longer meet the threshold if there are additional assessments or self-assessments. If the taxpayer is no longer in the safe harbor, the amount of the penalty would be computed taking into account only those payments made through March 31, 2005. Payments made after that date would be disregarded for purposes of computing the amount of the amnesty penalty.

The bill does not define the term "total tax."

FISCAL IMPACT

The department would incur minor and absorbable costs for systems reprogramming.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the revenue gain or loss from this bill would be as follows:

Estimated Revenue Impact Amnesty Penalty - 90% Safe Harbor Fiscal Year (in millions)			
	2004-05	**2005-06**	**2006-07**
Penalty Reduction	-$19	-$7	-$4
Acceleration	-120	60	60

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Revenue Discussion

This revenue estimate has two components. The first is a reduction in amnesty penalties. The second is an acceleration effect where taxpayers would withdraw some or all of their protective claim payments upon the adoption of this proposal. Revenue losses from the second component would be offset in future years by either increased payments or reduced refunds at the time the relevant cases are finally resolved.

The department has previously estimated total amnesty penalty revenue to be $168 million. Based on an analysis of those taxpayers who have filed protective claims, it is estimated that approximately 20% of these penalties will be paid by taxpayers with protective claims. Based on the same analysis, this safe harbor provision is estimated to eliminate 90% of these penalties ($168 million x 20% x 90% = $30 million). These losses are distributed across fiscal years based on earlier estimates of the timing of the amnesty penalty payments, and accrued back one year.

This estimate assumes that 5% ($170 million) of the $3.5 billion in protective claim payments will be withdrawn in response to this proposal and that the offsets will be spread over a three-year period. The outflow for fiscal year 2005/06 (on a cash-flow basis) will be $170 million less $50 million in offsets that flow back in later during the fiscal year equals $120 million. The remaining offsets will produce revenue gains of $60 million in each of the following two years. All estimates were then accrued back one year.

POLICY CONCERNS

Because 90% of total tax is the bright line for this safe harbor, taxpayers that fail to meet the 90% by even one dollar would still be subject to the penalty.

5. CHIEF COUNSEL RELIEF OF AMNESTY PENALTY

ANALYSIS

STATE LAW

The amnesty penalty imposed under Revenue and Taxation Code section 19777.5(a)(1) is an amount equal to 50% of the accrued underpayment interest payable under section 19101 for the period beginning generally on the original due date of the return for the taxable year to the last date of the amnesty period of March 31, 2005. This penalty applies to balances outstanding on March 31, 2005.

The amnesty penalty imposed under section 19777.5(a)(2) is an amount equal to 50% of the underpayment interest computed at the rate referenced in section 19101 for the period from the original due date of the return for the taxable year to the last date of the amnesty period, March 31, 2005. This penalty is applied for amounts that become due, including final deficiencies and amounts that are self-assessed, after March 31, 2005.

The penalty under section 19777.5(a) is a strict liability penalty, meaning that the penalty is applied without exception if the conditions described above exist. In addition, current law prohibits a taxpayer from filing a claim for refund for any amounts paid in connection with the amnesty penalty.

Taxpayers subject to certain tax shelter-related penalties may request the Chief Counsel of the Franchise Tax Board to grant relief. The standards of such relief depend on the specific penalty. For example, the chief counsel relief of the penalty under section 19773 for a reportable transaction understatement requires all of the following to apply:

- The taxpayer has a history of complying with relevant income tax laws.
- The violation is due to an unintentional mistake of fact.
- Imposing the penalty would be against equity and good conscience.
- Rescinding the penalty would promote compliance with relevant income tax requirements and effective tax administration.

THIS PROVISION

This provision would permit taxpayers to request the Chief Counsel of the Franchise Tax Board to grant relief from the amnesty penalty after it has been imposed if any of the following criteria exist:

- The taxpayer demonstrates that there was substantial authority, as defined, for the treatment of an item resulting in the underpayment on which the penalty was imposed.
- The taxpayer was first contacted after the end of the tax amnesty period by the IRS regarding examination, which results in a final deficiency or self-assessed amount upon which the penalty was imposed.
- Taking into account all the facts and circumstances, it would be against equity and good conscience to impose the penalty.

Also permit taxpayers to file a claim for refund of an amount paid in connection with the penalty on the grounds that the Chief Counsel's failure to grant relief was an abuse of discretion.

IMPLEMENTATION CONSIDERATIONS

Over 600,000 bills imposing the amnesty penalty will be mailed to taxpayers that did not successfully apply for amnesty and had balances due as of the end of amnesty. A substantial number of taxpayers receiving these bills may request relief. This would result in a high-volume workload for the department to process and analyze each request.

FISCAL IMPACT

This proposal would require additional resources to process a potentially large volume of requests for relief in the first year. FTB staff will continue to develop costs as the bill progresses.

ECONOMIC IMPACT

Revenue Estimate

Based on the assumptions and data discussed below, the revenue loss from this proposal is as follows:

Estimated Revenue Impact Chief Counsel Relief of Amnesty Penalty (in millions)		
2004-05	2005-06	2006-07
-$9	-$3	-$2

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Revenue Discussion

Based on the department's experience with penalty relief requests relative to other tax programs, it is assumed that the Chief Counsel would abate approximately 10% of amnesty penalties imposed in the initial years, dropping to 7% beginning with 2006/07. One specified standard for penalty relief relates to IRS contact after the end of amnesty for amnesty years. Since the normal federal statute of limitations for the 2002 taxable year will begin to expire in early 2006, the revenue impact resulting from granting relief based on this standard would become negligible in 2006/07.

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